DEPARTMENT OF STATE REVENUE

02-20060511.LOF

Letter of Findings: 06-0511
Corporate Income Tax
For 2002, 2003, and 2004

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I. Disallowance of Royalty Expenses – Adjusted Gross Income Tax.

Authority: IC § 6-3-2-2(m); IC § 6-8.1-5-1(b); *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 63 S.Ct. 1132 (1943); *Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981); *Sweetland v. Franchise Tax Board*, 13 Cal. Rptr. 432 (Cal. App. Ct. 1961).

Taxpayer protests the Department of Revenue's decision that taxpayer's expense deductions for royalty fees paid to a related entity should be disallowed.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the business of preparing and printing financial and business documents. The Department of Revenue (Department) conducted an audit review of taxpayer's returns and business records. The audit concluded that claimed royalty expenses should be disallowed on the ground that the claimed expenses did not fairly represent taxpayer's Indiana income. Taxpayer disagreed with the decision and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer's representative explained the basis for its protest. This Letter of Findings results.

I. Disallowance of Royalty Expenses – Adjusted Gross Income Tax.

DISCUSSION

During the years at issue, taxpayer paid royalty fees to a related entity located in California. The amount of royalties was based upon the taxpayer's monthly income. Taxpayer paid the royalty fees in exchange for the right to employ certain trademarks and logos and deducted those fees on their Indiana tax returns. The trademarks and logos were originally transferred by the New York parent company to the California entity in 1997 "in exchange for the assumption of any liabilities associated with said intangible properties." Taxpayer never owned the trademarks and logos.

The audit disallowed the claimed expenses because "[t]he payment of these royalties to an affiliated company significantly reduce[d] the amount of the income subject to tax in Indiana." In support of that position, the audit report cited to IC § 6-3-2-2(m) which states;

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The cited statutory provision provides the Department with authority to apportion or allocate income derived from Indiana sources among commonly owned organizations in order to fairly reflect Indiana income.

It is well-settled that corporations are free to adopt the corporate form and to engage in activities they deem appropriate. The Supreme Court has stated that the doctrine of corporate entity serves a useful purpose and that "so long as [the] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-439, 63 S.Ct. 1132, 1134 (1943). However, the Court continued, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." *Id*. at 439. The state courts have been consistent in applying this "business purpose" doctrine, holding that tax avoidance in and of itself is not a valid "business purpose." *See Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981); *Sweetland v. Franchise Tax Board*, 13 Cal. Rptr. 432 (Cal. App. Ct. 1961).

The taxpayer has provided evidence indicating that the California entity is an "operating company" which actively promotes and preserves the intellectual property at issue. The California entity engages in sales to third parties and – during 2004 – had approximately $25,000,000 in salary costs. The California entity operates out of more than six offices located in California and Washington state. The royalty payments received from taxpayer – along with royalty payments received by eight other non-Indiana entities – are employed by California entity as "working capital." The California entity does not loan the royalties back to taxpayer; the California entity does not return the royalties to taxpayer in the form of dividends. The royalties paid by taxpayer to the California entity constitute four percent of the California entity's royalty income. There is no indication that the California entity makes unaccounted for "interest" payments to taxpayer.

As noted in IC § 6-8.1-5-1(b), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

In this particular case, taxpayer has met its statutory burden of demonstrating that the audit's decision disallowing the royalty expenses is incorrect. The audit correctly noted that the claimed expenses "significantly reduce[d] the amount of the income subject to tax in Indiana." However, there is little to indicate that the royalty payments constituted an abusive tax avoidance scheme such that the claimed expenses did not "fairly reflect" taxpayer's Indiana source income.

FINDING

Taxpayer's protest is sustained.

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